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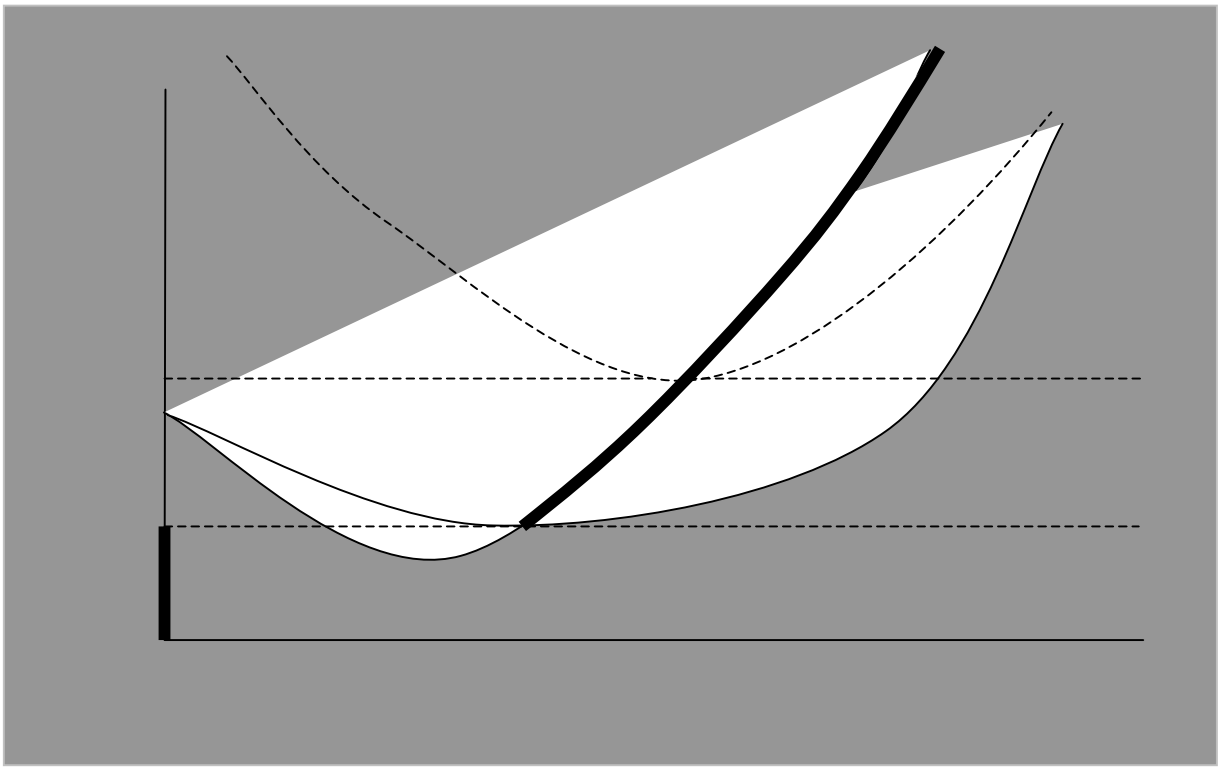
Vladimír Benáček: External Financing and FDI in Central, Baltic and South-Eastern Europe in 2002-2003



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A b s t r a c t

The paper assesses the developments in the financial accounts of the balance of payments in 15 transition countries in Central, Baltic and South-Eastern Europe. It is a follow-up of the IES working paper no. 49 of May, 2004, that dealt with the state of current accounts in these countries. In contrast to the early stages of transition when the external balance was often the source of economic instability in the region and required a deep undervaluation of the exchange rate, the performance of financial accounts reflects a high degree of restructuring, progressing advance patterns of integration and stability of these economies. The composition of foreign financing has been changing in the last 5 years. The risk of indebtedness, which would be unsustainable to disburse, has been declining, even though there are still present the dangers of a financial crisis is some countries due to the fiscal indiscipline and immodest wage hikes. In the last 5 years the FDI flows have been gradually changing both their direction and composition. Both of them indicate that financial capital shortage is not any longer the primary constraint on the development of these transition countries. The tendency towards financial flows, whose pattern is typical for stabilised advanced economies and which reflects the needs of post-industrial patterns of development, is present throughout the region.

Abstrakt

Článek se zabývá analýzou vývoje finančních účtů platebních bilancí 15 transitivních zemí ve Střední a Jihovýchodní Evropě. Navazuje na pracovní materiál WP IES č. 49 z května 2004, který se zabýval stavem běžných účtů týchž zemí. Na rozdíl od 90. let, když vnější nerovnováha byla častým zdrojem hospodářské nestability v tomto regionu, stav finančních účtů ve výrazné většině zemi se nyní stabilizoval a odráží pokroky v restrukturalizaci výroby a v intenzívní integraci s Evropskou unií. Struktura finančních účtů se v průběhu posledních 5 let změnila jak ve směrech svých toků, tak v kvalitě a začala se blížil ve svých charakteristikách účtům vyspělých zemí. Riziko neudržitelného zadlužování se nyní už nevyskytuje v žádné zemi, i když v několika případech stále hrozí to, že fiskální nedisciplinovanost a příliš vysoké požadavky na mzdové nárůsty změní deficit platební bilance v brzdu vysokého ekonomického růstu. I v těchto případech je ale zřejmé, že přístup k financím už není primárním omezením na rozvoj tranzitivních ekonomik. Finančním účtům nyní dominuje role přijatých přímých zahraničních investic. Současně ale roste význam reinvestovaných zisků, repatriovaných dividend a vývoz kapitálu. Disponibilita světových financí je tak vysoká, že zásoba oficiálních rezerv rostla ve všech 15 pozorovaných zemích.

Caveat for the readers:

A part of this analysis was used by United Nations, Economic Commission for Europe, in their Economic Survey of Europe, no. 1, 2004. This text therefore differs from the text finally published by UNECE both in contents and editing. For the purposes of quoting the official document, please turn at its final version at http://www.unece.org/ead/pub/041/041c3.pdf.

1/ The State of Financial /Capital/ Accounts in General

The year of 2003 was a sort of finishing spurt of the long-lasting preparations for eight of these countries before their accession to the EU in May 2004. Their economies have undergone 14 years of transformation and some of them have even overcome three recessions

from the adjustment requirements. Thus, at this rather closing stage of transition, we could find them well prepared for the integration with the EU. The economic growth was highly satisfactory in the majority of them and even the remaining seven economies of South-East Europe were performing very well in that respect.

The scenarios of convergence, especially due to highly favourable developments in the competitiveness of trade, could finally look more optimistic than ever before. The current accounts deficits did not pose a great danger because they did not require a large openness in the financial accounts for their financing. The risks for losing official reserves on that account did not look large even for those 2 or 3 countries that had the largest current accout deficit. We can characterise it that the quantity of foreign financing is yielding to the demands for its quality, which reflect the mature stage of their restructuring.

In January-September 2003, net financial flows to eastern Europe amounted to $27 billion, somewhat less than during the same period of 2002 (see table 1). Probably the record high level of net financial flows reported in 2002 will be difficult to reach in the near future as the privatization in the region (an important destination of external financial flows) has already passed its peak.[1] It could be expected that the present rate of net external financing (on average, between 6-7 per cent of GDP) will tend to stabilise or even decline. The rates of domestic savings are generally high in the majority of these countries and the reliance on large financial injections from abroad will probably diminish in the future. What is more important now is the quality and composition of foreign capital inflows: the proper match between external and domestic resources and the type of spillovers generated by foreign capital in the domestic markets.

In 2003 there was a notable shift in the direction of FDI inflows to different east European subregions. While FDI flows south-east European countries increased significantly, the net balance of FDI in acceding countries decreased sharply as a result of rising FDI outflows and due to a decline in inflows to all central European economies in the first three quarters of the year (table 2 and table 5). Other financial flows to east European countries were rather volatile (not only in 2003 but also in previous years). For example, in 2002-2003 the absorption of short-term funds increased in the majority of the acceding countries, especially in Poland, Hungary, Czechia and Estonia whereas the demand for long-term funds and portfolio investments was more pronounced in countries with lower FDI inflows (as the south-east European economies).

With a net contribution by $4.9 billion in the first nine months of 2003, long-term and portfolio investments were the most important source of external financing in south-east Europe. In virtually all 15 countries, effective financial flows (net of change in reserves) exceeded the absolute value of current account deficits, continuing a trend observable already in previous years. These economies (especially the acceding countries) are now generally considered as attractive by international investors, as is documented by relatively favourable ratings of their creditworthiness.[2] The purchases of foreign exchange by national banks in

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1 Between 1992 and 2002 the net financial inflows effectively absorbed by the economies (i.e. excluding the official reserves) increased more than 10-fold reaching $41.5 billion in 2002.

2 Thus six our of 15 countries were ranked in the first three deciles among more than 150 countries evaluated by Institutional Investor, Country Credit Ranking, as of September, 2003.

eastern Europe (in most cases aiming at easing the pressures on exchange rates) amounted to 1.8 per cent of the GDP (table 1).

2/ Capital Volatility and Policy Response

Contrary to expectations that the influx of foreign borrowing would weaken the exchange rate in transition countries, it reveals their sound foundations of restructuring as the exchange rates appreciate in real terms meanwhile the export competitiveness does not show signs of weakening. The high inflows of foreign funds, rising indebtedness and the state of monetary reserves (table 3) are having also a significant effect on the conduct of monetary policy in the eastern European countries, none of which has now a pure freely floating exchange rate regime. Many of them have a currency board monetary system or exchange rates that are not very volatile vis-a-vis euro. Exchange rate management under less flexible adjustment regimes carry certain risks, especially in an environment of high budget deficits. The later is the weakest side of monetary policy on many of them. A large influx of foreign capital generally exerts an upward pressure on the exchange rate; besides, it triggers a monetary expansion, which may lead to overheating and higher inflation. The result may be a further deterioration in the trade balance and even higher foreign borrowing pressure that is not on a sustainable performance path. A pressure for an appreciation may revert suddenly to a pressure for depreciation, as the case of Hungary showed in 2003.

There were three speculative attacks at forint in 2003 - in January, June and November. The speculators first attacked the the lower (appreciation) band of the fluctuation constraint. Already in 2001 the Hungarian National Bank (HNB) has declared a monetary regime copying the functioning of ERM-2, what may have been premature. A high interest rate attracted large capital inflows but the interventions of the HNB of more than € 5 billion in January 2003 avoided the danger of appreciation. However, after 2001 Hungarian deficit spending rose to 9.2% of GDP, the wages soared and the competitiveness of the domestic economy suffered. When in June the HNB depreciated the central parity of forint by negligible 2.26%, it weakened the credibility of sustainable macroeconomic policies, which triggered the capital flight. HNB had to raise the interest rate to 9.5 % in order to fend off the exchange rate decline and keep the inflation low. At the same time the substantial foreign financing of the government debt continued while the FDI inflows declined sharply. In November 2003 it was revealed that the position of Hungarian balance of payments was more fragile than expected. The interest rate was increased to 12.5% - by 10% higher than in the Eurozone - in order to keep the foreign capital in the country. It was a costly intervention that will have long-lasting negative impacts not only on the Hungarian economy.

On the other hand, sterilisation of the monetary overhang is a costly policy option and may be counterproductive, especially in the presence of interest differentials. Overall, with fully liberalised capital flows, appreciating equilibrium real exchange rates (related to their relatively fast growth) and still perceptible interest differentials, the acceding east European economies are particularly exposed to international financial pressures. Besides, such flows can be not only very high but also their net balances are subject to high volatility (tables 1 through 3). Under such circumstances, the degrees of policy freedom are rather limited, as was clearly revealed in the description of policy turmoil in Hungary. All these factors have probably prompted the national banks in some acceding countries to reconsider their previous

plans for early entry into the EMU. A conspicuous premature accession to euro can backfire, especially if the economy's adjustment to the market parameters of the customs union is not complete and the economy is not satisfying the criteria of optimum currency area.[3]

Subject to the recent findings about how the fundamentals of post-transition economies evolve, more economists are now prone to agree that the constraints built into ERM-2 are not commensurate with the natural mechanism of nominal and real convergence of transition countries.[4] With fully liberalised capital flows, appreciating equilibrium real exchange rates and investment yields higher than what present security yields offer in the rest of the world, the acceding east European economies are particularly exposed to international financial pressures. As is documented in tables 1 through 4, such flows can be not only very high but also their net balances are subject to high volatility. The trend for real appreciation, entailed by continued productivity and terms of trade gains, will have to come out either by nominal appreciation or by inflation in excess of EU partners.

Since this problem is intrinsically structural and not symmetric along all industries, commodities and enterprises, its solution rests more in price hikes than in the tolerated appreciation of exchange rate parity. If the ceiling prescribed for the inflation by ERM rules is too low, an early adoption of euro may become excessively costly. In addition, the problematic high "inflation" in transition countries may be in some cases only virtual – lacking the attributes of fiscal or monetary indiscipline. Rising prices may reflect the nominal convergence driven by productivity gains, upgraded quality and goodwill standards, structural change and unit labour costs in the traded sector, and the ensuing matching price mark-ups in the non-traded sector, as is well known from the most varied scenarios of the Balassa-Samuelson effect.

3/ Sustainability of the Balance of Payments and the Changing Patterns of FDI

Although most east Europe countries have been net debtors for at least a decade, their consolidated gross external debts (table 3) are still relatively small by international standards due to the high proportion of FDI and other equity components in their financial balance.[5] The gross external debt of all east European countries increased from 43 per cent of their aggregate GDP in 1995 to just 47 per cent in 2003. The rates of indebtedness are even more

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3 R. Horváth and L. Komárek, *Optimum Currency Area Theory: An Approach for Thinking about the Monetary Integration*. Warwick Economic Research Papers, no. 647, Univ. of Warwick, August, 2002. The readers can contrast a prudent gradual approach to euro with a jumpstart strategy for a unilateral euroisation hammered out by S. Gomulka, e.g. in his *Poland's Road to Euro: A Review of Options*. Paper presented at the conference of ONB in Vienna "Convergence and Divergence", November, 2001

4 D. Begg, B. Eichengreen, L. Halpern, J. von Hagen and C. Wyplosz, *Sustainable Regimes in Capital Movements in Accession Countries.* Policy Paper no. 10, London, CEPR, December, 2002. Paper available at http://heiwww.unige.ch/%7ewyplosz/. The policy implications of the ERM accession are discussed in more detail in chapter 3.1, part i.

5 The gross external debt of a country is defined as all recorded liabilities of residents to non-residents after the deduction of direct investment equity capital (including reinvested earnings) and other equity securities. According to the widely accepted definition, a "moderately indebted country" is one with a gross debt between 48 and 80 per cent of GDP.

favourable if the stock of official reserves (representing the international liquidity that can be used for disbursing the liabilities in case of emergency) is subtracted from the gross external debt. Such indicators of net debts cut the size of gross debts in eastern Europe by nearly a half. The levels of net indebtedness (gross debt less official reserves) actually declined or remained unchanged during the last two years in all countries, except Croatia, thanks to the fast growth of their official reserves. Thus, due to the total stock of official reserves of over $93 billion, the eight acceding countries (with the exception of Estonia) have substantial resources of their own for backing a smooth transition of their trade under the auspices of the customs union of the EU in 2004.

Official reserves (table 3) are an important hedging mechanism against attacks on domestic currency. Their level increased in all 15 countries in the last two years. That means, the "overall balances" of international payments were in surplus that was absorbed into reserves. It was an outcome of the commonly agreed policy of national banks to soften the impact of extensive financial inflows on the nominal appreciation of the exchange rate. The net positions of the eight acceding countries on medium- and short-term funds are generally balanced in maturity, reducing the risks of a liquidity crisis.

Until 2002 the flow of FDI to eastern Europe was steadily increasing. However, in 2003 the total flow abated by nearly 40 per cent, but only due to the decline of FDI going to the EU acceding countries, with the exception of Estonia (table 4). By contrast, the south-east European economies attracted increasing amounts of direct investment from abroad. The degree of dispersion of the FDI stock in eastern Europe as a whole (measured per GDP and per capita) has declined for the first time since 1993, which may be a sign that the previous trend of asymmetrical absorption of FDI in the countries of the region is about to be corrected or even reversed.

The fall in FDI going to central Europe (which followed the four years of massive inflows - see table 6) can be a delayed consequence of the sharp overall decline of FDI allocations in the world during 2001 and 2002. In these two years the total world FDI flows dropped by 53% to a mere $651 billion in 2002.[6] As 2003 brought only a slight recovery, the importance of eastern Europe and the CIS as a FDI attraction remained high. The slump in FDI flows reflected the global economic recession, the loss of trust in the "new economy" and an over-investment in large enterprises.[7] But it also reflected a change in the structure of the FDI inflows: a rapid decline in the share of privatization acquisitions (with privatization in central Europe running out of the course) and an increasing role of greenfield investments and investments from retained earnings. Nevertheless, acquisitions still represented more than a half of the inflows in 2002 and still considerable assets (in banks, public utilities, energy infrastructure and other sectors) remain in public hands in some of these countries. The data

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6 *World Investment Report, 2003*, United Nations and UNCTAD, 2003.

7 See Boston Consulting Group, *The Path to Value Creation, Global Corporate Banking 2003*, November, 2003, http://www.bcg.com/publications/files/
the_Path_to%20Value_Creation_Global_%20Corporate_%20Banking_Rpt_Nov%2003.pdf .

for 2002-2003 also suggest that countries that accumulated large FDI stocks might potentially become important FDI exporters (table 5).[8]

The attraction of capital and investors from abroad is a part of a more complex macroeconomic mechanism outlined in the study on current accounts in this part of Europe.[9] It is also strongly influenced by various microeconomic, policy and institutional factors.[10] The degree and the quality of foreign capital absorption in eastern Europe is a reflection of their perceived growth potential, endowment with natural resources, infrastructure, external economies, rising international competitiveness of labour, build-up of human capital, improvements in the protection of property rights and advances in the institutions of financial intermediation and, quite significantly, by their prospects for the EU membership.

During the period of economic transformation, eastern Europe has accumulated a potential for remaining among the world's leaders in FDI absorption. This prolonged attraction was not only due to some price competitiveness advantages (low wages, less regulation of businesses or weak trade unions) but mainly because the local conditions are favourable for the development of FDI in technologies and FDI dependent on human capital. The current average level of the FDI stock per GDP in eastern Europe (accumulated in less than 15 years) in 2003 was by 40 per cent higher than the world's average. At the same time, it was still significantly below the values of FDI per capita, customary in the less developed countries of the EU (for example, $4360 for Portugal or $5290 for Spain in 2002, relative to $1309 per capita for the whole eastern Europe).

The FDI inflows to eastern Europe have also been changing in their qualitative characteristics. Thus (as a common specialization pattern in the more advanced east European economies) foreign firms have expanded in sectors, which require more skilled labour and in those ones based on high technologies, leaving the activities requiring an intensive use of unskilled labour to domestic firms. In central Europe and Estonia the production of components in the context of multinational supply networks has become an engine of export growth since the mid-1990s. At present, between one third and one half of these countries' exports to the EU comprise components for the automotive, electronic, electric, office equipment, information technology, and rubber and plastic industries.[11] Another new development in the region is the widening of the linkages between local suppliers and the

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8 This provides a new and more robust evidence for the conjecture put forward in W. Andreff, "The New Multinational Corporations from Transition Countries". *Economic Systems*, Vol. 26, No.4, 2002, pp. 371-379.

9 The study is available as Working Paper of IES no. 49, Charles University, Prague. It can be downloaded from http://ies.fsv.cuni.cz/diplom_det.php?did=392&lng=ang According to its argument in chapter 2, any financial account deficit reflects the lack of domestic private savings driving the interest rate too high, or domestic savings unable to satisfy high demands for investments, or flawed domestic financial intermediation, and/or deep government deficits.

10 N. Campos and Y. Kinoshita, *Why Does FDI Go Where it Goes? New Evidence from the Transition Economies.* IMF, Washington, IMF WP/03/228, November 2003.

11 B. Kaminski and F. Ng, *Trade and Production Fragmentation: Central European Economies in EU Networks of Production and Marketing*. Policy Research Working Paper, The World Bank, June, 2001; G. B. Navaretti, J. Haaland and A. Venables, *Multinational Corporations and Global Production Networks: The Implications for Trade Policy*. CEPR, London, Report for the European Commission, 2002.

mother investment company, which increases even more the share of integrated products in their exports. The emerging clusters of supply and demand chains, based mainly in central Europe, have potential to become (moreover, after the EU enlargement) the nucleus of future industrial agglomerations.

4/ The emerging automobile cluster in Central Europe

Large strategic direct investments are able to overcome the limitations of small domestic markets and may breed the build-up of large clusters of suppliers around them. Hence, in terms of policy recommendations, locations in small economies with enterprises of only local importance, should seek first to establish a strategic link to the "core" in order to be able to evolve gradually into an integrated local hub. The emergence of a cluster of industries amalgamated by backward and forward linkages is therefore conditional on the establishment of a leader (or an oligopoly of leaders) whose size and progress could guarantee economies of scale.

The mushrooming of secondary greenfield firms and domestic services around the strategic enterprise can be illustrated by the development of automobile industry in central Europe. Its inception was laid by the acquisition of Škoda by Volkswagen in 1991. The output of Škoda motor vehicles increased two-fold during 1993-2002, reaching 446 thousand units. It initiated a booming market for the Czech production of car components, so that the employment in the whole automotive industry increased in the same period by 44 per cent, value added in constant prices by 187 per cent, real sales by 240 per cent and exports in nominal euros by 446 per cent. The dynamic growth of Škoda-Auto spilled over to the whole automobile industry, which grew at an average rate of 11.7 per cent (in real value added) in the period 1993-2002. Thanks to the accompanying learning process, local suppliers of components and car related services became so competitive that since 2002 the Czechia has been attracting the largest number of investment projects **in the automobile industry** in Europe, overtaking traditional leaders such as the UK and France.

Apart from the Czechia, the boom in automobile production is also present in Hungary, Slovakia and Poland, producing altogether over 1 million cars. Until recently, the cross-border cooperation between the automobile firms in the region was not intensive and dependence on the supply chains based in the current EU member states dominated both the production and the trade. A dramatic change can be expected to come when three additional plants will operate in the region (consortium Toyota-Peugeot-Citroen in the Czechia, PSA in Slovakia and Hyunday in Slovakia or Poland) and the total production of cars in the region will be almost 2.4 million cars a year by 2007. The new supply strategies count on a higher use of components produced locally, more intensive dependence on local top-notch business services and, after the abolition of existing economic barriers coming with the EU accession, deeper regional cross-border integration of firms. The resulting higher complexity of cooperation and competition in the car industry in the triangle Prague-Warsaw-Budapest offers all advantages of industrial agglomeration: specialised suppliers, pooling of specialised

labour markets, knowledge spillovers and strong leaders at the end of supply chain subject to both internal and external scale economies.[12]

The comparative advantage in cheap labour does not appear to be any longer the main attraction of eastern Europe. Instead of economising on variable costs such as wages, the strategic objective in modern industries moves to fixed cost economies and external economies associated with the cluster, in this case the car technology cluster. For example, a company that would enter the car industry in a location other than the mentioned triangle would be at an immediate disadvantage because it would be burdened with additional fixed and transaction costs that are much higher than the wage costs gains.

5/ Investment Promotion Agencies – the Cases of Irish and Czech Expertise

As a policy recommendation, the intermediary role and the cooperation of national investment promotion agencies are crucial elements in the fostering of such sophisticated transnational networks because their technological spillovers and other externalities create additional social returns that may be complementary to private returns to the strategic investors.

FDI positive spillovers in the technology transfers, supply linkages, build-up of agglomeration clusters, export penetration, market competition and human capital formation have all signs of positive externalities. At the same time there are risks of crowding-out of domestic firms, shrinking of forward and backward linkages, import penetration, abuse of the market power, hostile takeovers, corruption of public administration and closing down of local R&D centres. FDI penetration therefore bears strong aspects of public goods, what implies that its social returns may be different from private returns. Therefore the existence of FDI incentives may be justified and the surveillance over their provision should be commissioned to a specific body of public administration – to so called investment promotion agencies (**IPAs**). The problems of fuzzy boundary between the public and the private interests, legislative and economic constraints on the interference with market forces and conflicts between long-term and short-term aims pose an enormous challenge on the professionalism of IPAs.

The break-through came from Ireland with the establishment of IDA in 1969 (promotion of foreign investment) and Enterprise Ireland in 1993 (promotion of indigenous industries). The ensuing Irish miracle became a benchmark for industrial policies all over the world. Strangely enough, eastern Europe has one IPA – CzechInvest – that has been earning recently one prize of top European prestige after another. CzechInvest comes from a country that turned into a leader in FDI attraction as a latecomer. Its performance is based on the following principles:

a) It is a government institution following strictly the clearly specified mandate for social objectives in fostering high-quality FDI projects that contribute to national employment, competitiveness and growth.

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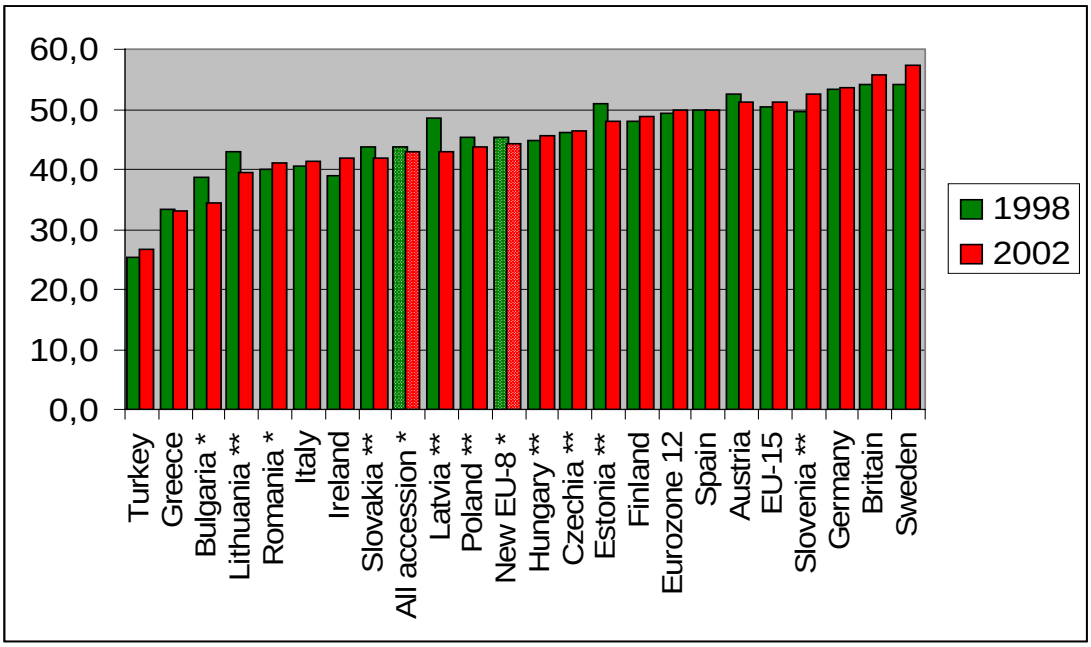
[12] P. Krugman, "Increasing Returns and Economic Geography," *Journal of Political Economy*, Vol. 99, No. 3, 1991, pp. 483-499.

b) The strict independence from the government is anchored only informally – by the professional prestige, ethics and maximal transparency of CzechInvest's activities.
c) It covers the complex of agendas associated with FDI, EU structural funds and indigenous business development.
d) CzechInvest in closely related to the government policies in investment incentive schemes, building of industrial zones and parks and general business development.
e) It has very stable and young board of top management.
f) Its activities vary from deeply regional up to world-wide
g) In personal policy the emphasis is given to a team building and a personal accountability in satisfying the complex business servicing for customers.
h) Given the objectives and the breakdown of strategic plan into operational internal objectives, the evaluation of people and the audit of processes is effected annually.
i) The experiences from the direct contacts with investment reality are fed back regularly to the government in order to fine-tune the climate for enterprise development.

Evidently, the quest for a model of an agency of high performance should not start from technical or organisational details but from the people, the ethics and the creation of a self-sustaining informal environment that is conducive to incentives for even higher achievements.

FIGURE 1: Share of the total compensation of employees in GDP, 1998 and 2002
(in per cent of GDP)



Source: Eurostat, New Cronos, March, 2004

6/ Human Capital, Labour Costs and Competitiveness

Human capital is gradually superseding the role of simple labour as the primary factor of comparative advantage of the east European economies mainly due to the changing pattern of specialisation by foreign enterprises. Nevertheless, the role of competitive wage rates should not be underestimated. Labour costs in eastern Europe, both in terms of the absolute

level of the wage rates and in relative terms, as a share of total costs (which on the aggregate level can be illustrated by the share of total compensation of employees in GDP - see figure 1) are still relatively low compared to developed market economies. In table 6 the difference to 100 per cent is an aggregate measure of the gross profit margin, or return on capital. Even though this margin on average is still higher in eastern Europe than in the EU, the average premium of 13.5 per cent is not large.

However, in recent years nominal wages in some of the east European countries have tended to grow faster than productivity, which can undermine the cost competitiveness of the enterprises in the tradable sector. Hungary is the most typical example where the payrises in the public sector, as a part of electoral campain, spilled over to the private sector incommensurably to the productivity advances. In addition, there is the danger of wage spillovers from more productive foreign-controlled firms to less productive domestic enterprises. The problem rests in the dual nature of these economies characterized by considerable productivity differentials; due to this, although absolute wages in domestic firms can be lower than those in foreign-controlled firms, in relative terms they can still be higher, reducing further the returns to capital in the indigenous sector.[13] Hence, any pay rise that is not justified by productivity gains can weaken further the viability of domestic firms, meanwhile the foreign firms can absorb it easier.

Even though the service sector – real estate, financial intermediation, retail trade, telecommunications – has dominated the structure of FDI inflows to eastern Europe in nearly all countries (accounting for over 60 per cent of all FDI flows in central Europe and even more in the Baltic states), a new trend has emerged recently of a growing number of FDI projects in the fields of information networks, research and development and business support, offering jobs in high skill and knowledge-based activities.[14]

The penetration of foreign capital in the sector of corporate banking in some east European countries is really unprecedented, as is demonstrated in figure 2. Thus while foreign ownership in the banking sector in four of the central European countries is now around 80 per cent, in the Eurozone it is still of marginal importance. In the EU, mergers and acquisitions mainly occurred inside the domestic banking sector and the role of foreign penetration by establishing cross-border branches was minimal. Only in Ireland and Luxembourg the market share of foreign banks exceeds 10 per cent. United Kingdom is the only exception to the rule of domestic dominance, with a penetration rate of banking by branches from the EU alone by holding 23.7% of the total value of balance sheets in the country in 2001. [15]

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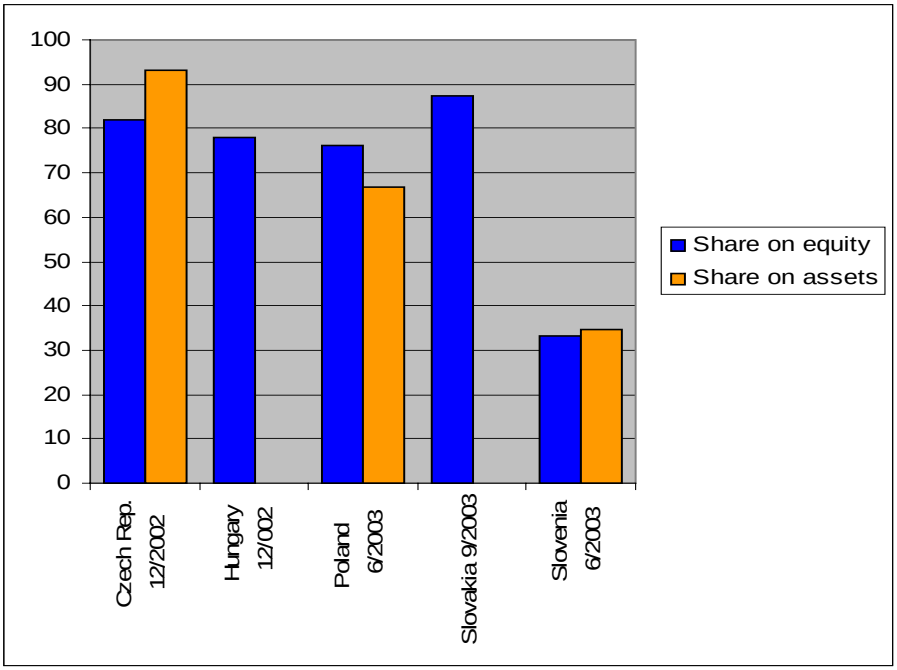
13 A. Zemplinerová, op. cit.

14 The current investment by one of the world's largest logistics companies DHL (which is relocating its IT activities from Britain and Switzerland to the Czechia) is seen by many of a similar significance as the Volkswagen investment in 1991 that initiated the build-up the fastest growing automobile cluster in Europe.

15 K. Mérö and M. E. Valentinyi, *The Role of Foreign Banks in Five Central and Eastern European Countries*. Hungarian National Bank, Working Paper no. 10, November, 2003.

FIGURE 2: Foreign ownership of the banking sector in central Europe, 2002-2003
Proportion of foreign banks' equity capital and assets on national total in per cent



Source: Statistics of national banks, March, 2004

In eastern Europe the cross-border takeovers helped to capitalise the troubled domestic banks and improved their efficiency. That was a crucial point because in the early stages of transition the allocation of private savings into investments resulted in loans to enterprises without much growth, what in some countries (e.g. Czechia, Slovakia and Romania) caused a proliferation of large bad debts. There are fears that the anomaly in the foreign management of banks could be pro-cyclical in their response to domestic shocks and subject to contagion originating in home countries. Since the phenomenon of mass foreign ownership of banks in developed countries is rather new in the world of banking, there is only an inconclusive evidence from Latin America that sheds little light to the question how the foreign banks in Eastern Europe will react to a serious crisis in the region.

The cross-border takeovers played a very important role for the restructuring of eastern Europe's the banking sector: the new owners injected new capital (to recapitalize troubled domestic banks) and managerial know-how, reorganized the bank's structure and operation, introduced new banking products, all of which produced significant efficiency gains. Successful, highly profitable acquisitions in the East European financial markets have contributed to a rapidly growing prices of the foreign investing banks' equity. Given their expanding holdings in eastern Europe, such smaller regional banks (e.g. Erste, Raiffeisen or KBC), may become attractive targets for takeovers by much larger banks from USA, Germany or France, whose strategy is to break the existing national barriers in the European banking retail business.

7. Conclusion: Fight for a Model Central /East/ European

The stereotypes of anecdotal evidence say that an East European is a person who abuses the collective system by taking a larger share of gains at dumping the costs on others, who blames his problems on external hostility and who impedes his neighbour's success. This picture is a prisoner's dilemma trap where all participants are relatively worse off at the end. A model inverse of such a person is someone who upgrades the system at his/her own costs, who takes the responsibility for his actions and who loves his country against all odds. This later story is an acknowledgement of the superiority of collective gains against private gains and of strategic gains over the tactical ones.

In reality, there is nothing particular in the trade-offs between such contradictory social choices, as the theory of public choice shows. It is an everlasting problem of all social systems and the balance between alternative choices may change in time. As was explained by Baumol or by Olson, it is the tuning of the system of institutions that strikes the difference between a predation and a collective action.[16] After the weathering-out of the stormy 90s, when rent-seeking and the drive for redistribution molded a large part of the domestic development in the majority of our 15 analysed countries, much more people in post-communist countries now realize that their future is associated with a need for a more collectively responsible behaviour. Instead of accumulating debts abroad, the transition countries in Europe concentrate more on FDI and domestic resources. That sounds like a promising new strategic orientation in their development, which would be potentially able to eliminate the burden of their past transition tangle.

We have seen that 15 transition countries from Central, Baltic and South-East region share several converging common features in tackling the crucial problem of external balance. Their financial accounts are able to finance the current account deficits in a sustainable way, pointing to the existence of natural equilibrium in their intensive integration with the world economy and especially with the EU. The prevailing pattern of the "division of labour" in the financial transactions, where FDI inflows play a dominant role, is mutually advantageous for all cooperating parties. It brings substantial returns to both the foreign investors and the domestic economy, in addition it allows for the buildup of monetary reserves that strengthen the domestic monetary position in both the capital sharing with the Eurozone and the revamping of the domestic economy. Thus the advances in the external sector became an engine of development and stability of the national economies in the studied 15 countries.

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[16] W. J. Baumol, "Entrepreneurship: Productive, Unproductive and Destructive". *J. of Political Economy, 98*, p. 893-921
Olson M., *The Rise and Decline of Nations*. Yale Univ. Press, New Haven, 1982
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TABLE 1: Net financial flows into eastern Europe, 2001-2003 Million dollars, per cent

Country or region	Capital and financial account flows **a** (million dollars)				Capital flows / GDP		Change in official reserves **b** (million dollars)		Change in reserves / GDP **b** (per cent)	
			Jan.-Sep.			Jan-Sep.		Jan.-Sep.		Jan.-Sep.
	2001	2002	2002	2003	2002	2003	2002	2003	2002	2003
Eastern Europe	29537	41349	29641	27099	8,0	6,1	15436	7840	3,0	1,8
Albania	363	435	322	336	9,0	7,6	29	79	0,6	1,8
Bosnia and Herzegovina	2067	1620	969	1449	29,9	29,3	-109	47	-2,0	0,9
Bulgaria	1117	1299	413	1428	8,4	10,1	586	595	3,8	4,2
Croatia	2038	2605	1541	1265	11,6	6,0	697	742	3,1	3,5
Czechia	5038	11043	9528	4025	15,0	6,5	6627	364	9,0	0,6
Estonia	292	854	550	960	13,1	15,6	55	62	0,8	1,0
Hungary *c*	1658	872	-168	5131	1,3	8,5	-1784	1249	-2,7	2,1
Latvia	1037	649	414	741	7,7	10,2	2	92	0,0	1,3
Lithuania	899	1157	681	981	8,4	7,6	423	226	3,1	1,8
Poland	6728	7339	5947	4401	3,9	2,9	639	1437	0,3	1,0
Romania	3707	3327	2365	3076	7,3	8,1	1802	1245	3,9	3,3
Serbia and Montenegro	1139	2842	2171	2459	18,1	16,9	1111	1068	7,1	7,4
Slovakia	1890	5585	3988	331	23,1	1,4	3646	258	15,1	1,1
Slovenia	1245	1529	766	265	7,0	1,3	1842	330	8,4	1,6
Macedonia	321	195	152	250	5,3	7,4	-131	46	-3,5	1,4
Memorandum items:										
EU acces. countries-8	18785	29027	21708	16836	7,2	4,9	11451	4018	2,8	1,2
Baltic states	2227	2660	1645	2683	9,3	10,2	480	380	1,7	1,4
Central Europe	16558	26367	20062	14154	7,1	4,5	10971	3638	2,9	1,2
South-east Europe	10752	12322	7933	10263	10,9	10,2	3985	3822	3,5	3,8

Source: UNECE calculations, based on national balance of payments statistics and IMF, Staff Country Reports (Washington, D.C.)

a Includes errors and omissions; excludes changes in official reserves

b A negative sign indicates a decrease in reserves.

c Excludes reinvested profits (net inflow).

TABLE 2: Net financial flows by type of capital into eastern Europe, 2000-2003 Billion dollars

Type of capital	EU acceding countries 8 a				South-East Europe countries b			
				Jan.-Sep.				Jan.-Sep.
	2000	2001	2002	2003	2000	2001	2002	2003
Capital and financial account **c**	19,2	14,3	27,4	16,4	6,7	9,3	13,1	10,6
Capital and financial account **d**	22,0	18,8	29,0	16,8	6,8	10,8	12,3	10,3
of which:								
FDI	17,3	17,4	20,2	5,8	3,6	4,3	3,6	4,3
Portfolio investment	1,7	3,3	1,3	0,8	0,6	1,2	0,0	1,4
Medium-, long-term funds	2,5	-1,6	0,4	1,9	2,9	2,5	4,7	3,5
Short-term funds	-2,7	-5,1	5,1	7,9	-1,0	0,6	3,8	0,7
Errors and omissions	2,8	4,4	1,6	0,4	0,1	1,5	-0,8	-0,4
Capital account	0,4	0,3	0,3	0,0	0,5	0,6	0,8	0,5
Short-term investment **e**	1,8	2,6	8,1	9,1	-0,3	3,3	3,1	1,8

Source: UNECE secretariat estimates, based on national balance of payments statistics.

a Includes Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

b Includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro and

c Excluding errors and omissions and the change in official reserves.

d Including errors and omissions, but excluding the change in official reserves.

e Includes portfolio investments, short-term funds and errors and omissions

TABLE 3: Selected external financial indicators for eastern Europe, 2001 and 2003 Million dollars, per cent

Country or region	Gross debt, national data (million dollars)		Gross debt/exports (per cent) a		Gross debt/GDP (per cent)		Official reserves				Net debt relative to (per cent)	
							Million dollars		Months of imports			
	2001	2003 b	2001	2003 b	2001	2003 b	2001	2003 b	2001	2003 b	2001	2003 b
Eastern Europe	212605	292536	106	102	46	47	79922	121096	4,0	4,3	62	59
Albania	1199	1300	120	87	28	22	740	949	5,0	4,4	38	27
Bosnia and Herzegovina	2600	2700	137	110	56	39	1221	1510	3,3	2,9	53	44
Bulgaria	10616	12381	135	109	78	62	3291	5503	4,3	4,7	69	56
Croatia	11317	19973	113	132	57	68	4703	7058	4,8	4,4	58	65
Czechia	22374	28389	52	47	37	30	14341	25556	3,7	4,6	36	10
Estonia	3279	5936	63	84	59	69	820	1174	1,7	1,6	75	80
Hungary	32683	49313	82	94	63	56	10727	12778	3,1	2,6	67	74
Latvia	5570	8415	151	164	73	83	1149	1396	3,1	2,5	79	83
Lithuania	5268	7220	84	73	44	39	1618	2823	2,7	3,0	69	61
Poland	71900	93266	195	188	39	45	25648	31595	6,1	6,0	64	66
Romania	12327	18580	89	84	31	33	5442	8785	3,8	4,0	56	53
Serbia and Montenegro	11740	13314	420	340	103	66	1005	3222	2,3	4,5	91	76
Slovakia	11043	15386	71	57	53	47	4141	10023	2,9	4,4	63	35
Slovenia	9182	14632	78	87	47	52	4330	7876	4,4	5,6	53	46
Macedonia	1507	1731	104	97	44	37	745	849	4,4	3,7	51	51
Memorandum items:												
EU accession countries-8	161299	222557	100	98	45	46	62774	93221	4,1	4,3	61	58
Baltic states	14117	21571	93	98	56	58	3587	5393	2,5	2,4	75	75
Central Europe	147182	200987	100	98	44	45	59188	87828	4,2	4,5	60	56
South-east Europe	51306	69979	132	120	53	49	17147	27875	4,0	4,2	67	60

Source: National statistics; The World Bank; *International Financial Statistics* , 2003 and UNECE Geneva.

a Total exports and factor income receipts. Total imports and factor income payments, respectively.

b Gross debt at end September 2003.

TABLE 4: Inflows and stocks of FDI in eastern Europe, 2002-2003 **Million dollars; dollars; per cent.**

Countries, regions	Inflows: Million dollars 2002	Inflows: Million dollars Jan-Sep 2002	Inflows: Million dollars Jan-Sep 2003	Inflows: % / GDP *b* Jan-Sep 2003	Cummulative net inflows (stocks) *a*: USD mil. September 2003	Cummulative net inflows (stocks) *a*: % / GDP *b* September 2003	dollars per capita *b* Sep 2003	% of EE average per capita
Eastern Europe	25491	19786	11731	2,7	164848	37,3	1309	100
Albania	135	94	108	2,4	1029	23,1	297	23
Bosnia and Herzegovina	293	178	206	4,2	1014	20,5	236	18
Bulgaria	905	636	925	6,6	5951	42,2	766	59
Croatia	1124	785	1180	5,6	8765	41,8	1973	151
Czechia	9305	8159	4004	6,5	42697	68,9	4186	320
Estonia	285	217	640	10,4	3817	61,9	2809	215
Hungary ***c***	858	662	-743	-1,2	24856	41,3	2447	187
Latvia	382	342	249	3,4	3281	45,3	1403	107
Lithuania	732	545	126	1,0	3743	29,0	1079	82
Poland	4119	2659	2452	1,6	41979	28,1	1098	84
Romania	1144	803	1099	2,9	9958	26,1	445	34
Serbia and Montenegro	475	310	883	6,1	2538	17,5	305	23
Slovakia	4012	3391	472	2,0	10618	45,2	1974	151
Slovenia	1644	942	96	0,5	3638	18,1	1823	139
Macedonia	77	64	34	1,0	962	28,5	471	36
Memorandum items:								
EU accession countries-8	21338	16916	7295	2,1	134630	39,4	1841	141
Baltic states	1399	1104	1015	3,9	10841	41,2	1513	116
Central Europe	19939	15812	6280	2,0	123789	39,3	1877	143
South-east Europe	4153	2870	4436	4,4	30218	30,1	572	44

Source: National balance of payments; IMF*Statistics and Staff Country Reports*; UNECE estimates.

a Net of residents' investments abroad: Bulgaria, 1990-1994; Poland, 1990-1992; Macedonia, 1990-1998.

b National forecasts of the GDP for the 3rd quarter of 2003 and the population for 2003 are used in the denominator.

c Excludes reinvested profits; otherwise the Hungarian FDI inflows in September 2003 would be higher by approximately $1.65 billion and by $2 billion in 2002 (according to the estimates of the Hungarian National Bank).

TABLE 5: Outflows of FDI from eastern Europe, 1990-2003 *a*

(Million dollars)

Country or region	*Cummulative 1990-2000 b*	*2001*	*2002*	*Jan-Sep 2003*	*Cummulative 1990-2003 b*
Eastern Europe	-3925	-1127	-1703	-1578	-8333
Albania	2	0	0	0	2
Bosnia and Herzegovina	0	0	0	0	0
Bulgaria	18	-10	-29	-15	-36
Croatia	-390	-155	-533	-42	-1119
Czechia	-705	-165	-276	-122	-1268
Estonia	-342	-200	-132	-117	-791
Hungary ***c***	-1857	-346	-265	-720	-3187
Latvia	42	-12	-8	-26	-5
Lithuania	-45	-7	-18	-31	-100
Poland	-468	-67	-330	-248	-1113
Romania	-21	17	-16	-41	-61
Serbia and Montenegro	0	0	0	0	0
Slovakia	-3	-37	-5	-1	-45
Slovenia	-152	-145	-93	-215	-604
Macedonia	0	-1	0	0	-1
Memorandum items:					
EU acces. countries - 8	-3534	-979	-1126	-1479	-7117
Baltic states	-348	-219	-157	-174	-899
Central Europe	-3186	-759	-969	-1305	-6218
South-east Europe	-391	-148	-578	-99	-1215

Source: National balance of payments statistics; IMF and UNECE estimates.

a Outflows of FDI from the reporting countries. A negative sign indicates a net outflow of capital by national economic residents. A positive sign indicates a net repatriation of such capital.

b Totals include UNECE secretariat estimates for countries for which data were missing for 1990-95: all of these had negligible FDI outflows.

c Excludes reinvested profits.

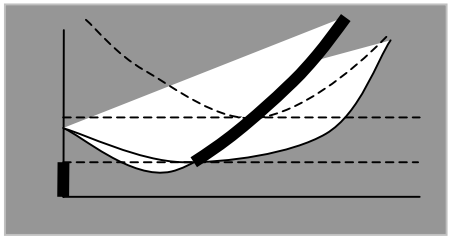
TABLE 6: Inflows of foreign direct investment in Central and South-eastern Europe, 1990-2002 (in million US dollars) a

Country or region	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Eastern Europe	..	..	..	..	..	..	8756	11374	17547	20136	21855	22807	25491
Albania	0	0	20	68	53	70	90	48	45	41	143	207	135
Bosnia and Herzeg.	..	..	..	..		0	0	0	0	67	177	146	125	293
Bulgaria **b**	4	56	41	40	105	90	109	505	537	819	1002	813	905
Croatia	0	0	16	120	117	114	511	533	932	1467	1089	1561	1124
Czechia	132	513	1004	654	869	2562	1428	1300	3718	6324	4986	5641	9305
Estonia	..	..		82	162	215	202	151	267	581	305	387	542	285
Hungary **c**	311	1459	1471	2339	1146	4815	2364	2229	2083	2012	1697	2599	858
Latvia	..	..		29	45	214	180	382	521	357	347	410	164	382
Lithuania	..	..		8	30	31	73	152	355	926	486	379	446	732
Poland **b**	10	117	284	580	542	1132	2768	3077	5130	6474	8293	6995	4119
Romania	0	40	77	94	341	419	263	1215	2031	1041	1037	1157	1144
Serbia and Monten.	..	..	..	..	..	..	0	740	113	112	50	165	475
Slovakia	18	82	100	195	269	308	353	220	684	390	1925	1579	4012
Slovenia	4	65	111	113	117	151	174	334	216	107	136	370	1644
Macedonia **b**	..	..	..		0	24	9	11	30	128	33	175	442	77
Memorandum items:													
EU acces. countries-8	..	..		3089	4118	3403	9421	7772	8303	13694	16446	18214	18336	21338
Baltic states-3	..	..		119	238	460	454	685	1142	1863	1139	1176	1152	1399
Central Europe-5	476	2236	2970	3880	2942	8967	7087	7161	11831	15307	17038	17184	19939
South-east Europe	..	..	..	..	..	..	984	3070	3853	3690	3641	4471	4153
Russia	0	100	1454	1211	690	2065	2579	4865	2761	3309	2714	2748	3442

Source: National balance of payments statistics; IMF, Balance of Payments Statistics and Staff Country Reports; UNECE estimates.

a Inflows into the reporting country.

b Net of residents' investments abroad. Bulgaria, 1990-1994; Poland, 1990-1992; Macedonia, 1990-1998.



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